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SUBJECT: CHINA/ENERGY: FUEL SHORTAGES TIED TO INDEPENDENT
COMPANIES' SWING CAPACITY

REF: BEIJING 06396

SUMMARY

¶1. (SBU) China's ongoing struggle with fuel shortages underscores the role of both independent refiners, which control approximately 15 percent of capacity, and independent retailers, which run half of the country's filling stations. Experts we spoke with believe that last week's gasoline and diesel price increases are insufficient to bring most independent oil refiners back into the market. Meanwhile, national and provincial independent oil associations are laboring to give their members more voice and presence in the market. This includes looking abroad for partners and stressig the need for improved product quality. Howver, the Central Government appears intent on marginalizing the independents -- in part on environmental grounds -- and at least one province we just visited is following suiT Given the inability of government-run oil companies to expand refining capacity rapidly enough to compensate for any loss of independent supplies (amid rapidly rising fuel demand), Beijing appears stuck with the independents for the time being. This awkward mixture of capped prices with dependence on market-incentivised producers/sellers will likely leave the government struggling with the choice between filling station shortages or consumer resentment against higher costs as long as international oil prices remain at current levels. END SUMMARY

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ONE WEEK ON, LOCAL PRESS DEBATES OIL PRICING MOVE
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¶2. (SBU) One week after Beijing raised gasoline and diesel prices in hopes of alleviating growing fuel shortages (ref), local Beijing newspapers are highlighting the debate over the move's merits. On one side stand China's national oil companies (NOCs), which assert that their oil refinery operations are still losing money despite the price increase. They cite their warnings months ago to the Chinese Government that prices should increase. Standing in opposition, local consumers are unhappy at paying more for fuel while the NOCs earn large profits (the companies' refinery losses are more than offset by profits in other areas, such as petrochemicals). There is also growing backlash against the high salaries and lavish benefits many locals claim NOC employees earn. The China Economic Times, the official newspaper of the State

Council's Development Reform Commission (DRC), reports that the Chinese Government is considering both viewpoints as it monitors the country's oil supply situation.

EXPERTS SEE NEED FOR FURTHER PRICE HIKES

¶3. (SBU) A senior DRC official told Emboffs this week that the shortages suggest a need to end regulated refined oil product prices and pass along the true costs of energy prices to consumers, in part to encourage conservation. Separately, a Sinopec (the top refining company) executive told us that the price increase is insufficient to bring independent refiners back online in forc_ (Note: Independents are estimated to account for 12 to 19 percent of refinery capacity. End note.) Sinopec is buying oil and refined lQ9QLBUproducts in the international market and increasing its refinery output to ease the shortage, said the executive.

¶4. (SBU) The Sinopec executive said Bhe company expects international oil prices to fall by late-December. The firm is paying close attention to the impact of rising oil prices on the United States economy, since oil prices might soften if the economy cools. Executives from a major international oil company we spoke to agreed that many independents probably will remain on the sidelines. Sinopec and other Chinese national oil companies (NOCs) are incapable of fully making up for the capacity loss, according to the western executives.

ROLE OF INDEPENDENTS COMES TO LIGHT

¶5. (SBU) The recent gasoline and diesel shortage has brought the role of Chinese independent oil companies into the light. A senior

official in China's independent oil association, the China Chamber of Commerce for the Petroleum Industry (CCCPI), told us this summer that the 1,000 plus CCCPI members do business throughout the domestic oil supply chain, but are most prominent in the refinery and retail sectors. China's independent refiners possess more than one million barrels per day of capacity, around 15 percent of total, and independent retailers operate some 50,000 gas stations, half of China's total.

¶6. (SBU) The CCCPI official said that independent refiners rely on a mixture of imported fuel oil (fuel oil is exempt from China's strict crude oil import restrictions) and crude oil supplied by the NOCs to supply their refineries. Similarly, independent oil retailers rely heavily on the NOCs for gasoline and diesel supplies -- their Achilles Heel, he suggested. The vulnerability for the independents surfaces when the NOCs restrict supplies during fuel shortages in favor of their own filling stations. The NOCs also disrupt supplies as a way to counter business threats, such as on one occasion several years ago when they drove an independent lubricant company from the market. The CCCPI official added that the NOCs also frequently target independent gas stations in areas where they want to expand their retail business. (Comment: The CCCPI official did not mention the role of theft. Other experts have told us that as much as 10 percent of China's domestic oil production is siphoned off, mostly to independent refiners. Shengli oilfield in Shandong Province alone likely loses more than 100,000 barrels per day. End Comment.)

INDEPENDENTS LOOK ABROAD FOR SUPPLIES...

¶7. (SBU) The CCCPI officials said that the independents have tried to get around their supply problems by looking abroad for alliances with foreign governments and companies. The association now has ties with similar organizations in Canada, Kazakhstan, and Russia to facilitate interaction between its members and private companies in those countries. For example, 40 CCCPI member companies attended a 2006 oil and gas forum in Pakistan resulting in several deals.

CCCPI hopes that some member companies will develop exploration and production opportunities abroad later this year, said the official.

...WHILE TRYING TO IMPROVE THEIR COMPETITIVENESS

¶8. (SBU) The CCCPI official stated that independents need to improve their competitiveness. Most important is improving product quality, which would make independents more attractive to retailers as an alternative to NOC suppliers. Independents also must improve their after-sale services and where possible expand their sales territory. Such improvements require cooperation among the independents that so far has been lacking. The official said that the association hopes that a large independent group company can evolve if such cooperation materializes. The previous attempt at an integrated private oil company, the Great Wall Oil Company, failed, but the association believes that such a company is still possible, said the official.

BEIJING REGULATORY MOVES CONSTRICT INDEPENDENTS

¶9. (SBU) Despite the association's optimism, Beijing has issued new regulations that restrict the independents as a market force. New foreign investment regulations issued on November 7 include prohibitions on foreign firms investing in refineries with less than 160,000 barrels per day of capacity. This limits independent refiners' access to outside capital and cuts off a possible alternative source of oil to refine. Earlier this year, Beijing began opening up its oil import market. The CCCPI publicly called for 600,000 barrels per day of licenses to be given to independents. Instead, Beijing limited the independents to 135,000 barrels per day. Furthermore, Beijing spread the licenses across 15 companies, effectively diluting any one company's market impact.

VIEW FROM PROVINCES EQUALLY BLEAK FOR INDEPEDENTS...

¶10. (SBU) A representative for an independent oil company association in Shandong Province, the Shandong Chamber of Commerce for Petroleum and Clean Fuel Industry (SCCPI), recently told Econoff that inadequate supplies constantly plague its members as well. SCCPI members hope better ties with local and foreign businesses can help alleviate this persistent problem. Local independents recognize a need to improve the quality of petroleum products if they want to become more competitive. Independent retailers frequently sell poor quality fuels and lubricants, often advertised and priced as high-end goods. The SCCPI representative said that his organization is in frequent contact with the national independent oil company association and has ties to similar provincial associations in Guangdong, Heilongjiang, Hebei, Jiangsu, Xinjiang and Zhejiang.

... AS LOCAL GOVERNMENT TURNS UP HEAT

¶11. (SBU) A senior Shandong Development and Reform Commission (DRC) official told us that local independents oil companies face a grim future. Independents must invest in technology upgrades and reduce emission levels if they want to stay in business much longer. Independent refiners in the province have long been supported by local governments because of the jobs and tax revenue provided by the companies. This protection is in jeopardy. The Shandong DRC official said Shandong Province supports Beijing's goal of closing down small, inefficient, and environmentally unfriendly industrial plants. An energy consultant in Beijing told us that several very profitable independent refiners in Shandong Province recently closed because they recognized that their local and provincial government protection would likely soon run out.

COMMENT: CAN'T LIVE WITHOUT THEM

12B(SBU) China's recent fuel shortages are largely a result of independent refiners being forced to shut down because regulated refined oil product prices offer insufficient margins when set against the cost of imported oil. Although new environmental regulations appear on the surface to threaten the futureNof the independents, China's oil companies cannot possibly build refineries and gas stations fast enough to meet the country's rising demand to compensate for the capacity loss. Beijing could obviate the need for some of the independents by allowing the market to set fuel prices and further opening its market to foreign oil companies eager to do business here. An Exxon Mobil official recently told us that the company already has a joint venture refinery in Fujian and a co-branded retail network, although it too claims to be losing money on refinery operations. Exxon officials say that although Sinopec agreed in principle to share government subsidies for losses on the refinery project, they have yet to receive any payments.

¶13. (SBU) However, both options -- market pricing and market access for foreign companies -- threaten the NOCs. These factors taken together suggests the independents are likely to remain a fixture of China's fuel market for the foreseeable future -- and the government may well struggle with fuel shortages so long as it keeps oil prices well below international prices.

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